Paving the Way Forward for Rural Finance
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Case Study

Regulation for Expanding Rural Financial Services

USAID Azeri Rural Credit Project (ARC)
Capitalization, Governance, Ownership, Control

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This case study was made possible by support provided in part by the US Agency for International Development (USAID) Agreement No. LAG-A-00-96-90016-00 through Broadening Access and Strengthening Input Market Systems Collaborative Research Support Program (BASIS-CRSP) and the World Council of Credit Unions, Inc. (WOCCU).

1. **Country Overview** - The Republic of Azerbaijan lies between Georgia and Russia to the north and northwest respectively, Iran to the south, Armenia to the west and bounded to the east by an approximately 700 km long Caspian Sea shoreline. The country has a land mass of 86,000 square kilometers and a population of plus/minus 8.0 million of which over 3.0 million reside in greater Baku with the balance spread among the smaller cities, towns, villages and rural areas. The topography of the country consists of the Greater Caucuses Mountains and forested slopes in the north and to the west; a large central plain of arid steppes; and a sub-tropical, verdant and fertile zone to the southeast. Average rainfalls amount to approximately 360 mm with mean temperatures averaging 3.5 degrees C during the winter and an average summer temperature of 27 degrees C.

Azerbaijan declared its independence from the crumbling USSR in 1991 and in the aftermath, war erupted with Armenia in 1992 resulting in the establishment of the enclave of Nagorno-Karabakh, still populated today mainly by Armenians and forcing approximately 850.0 thousand Azeri refugees to flee the occupied area. Azerbaijan remains a member of the Commonwealth of Independent States.

The large majority of the people in present-day Azerbaijan are Muslim and speak Azeri a language related to Turkish, with the Russian language representing a decreasing minority and English quickly becoming the favored second language. Of a working age population of 4.89 million people approximately, 3.76 million were economically active. It should also be added that according to World Bank official statistics, upwards to 60% of the entire population still exist within the poverty stratum.

Although statistical indicators vary widely according to the source, the following will give some measure of Azerbaijan's economic activity in 2002[1]:

- Electricity production at 17.6 billion kilowatt hours
- 1.6 million telephones and 160,000 televisions were in use
- There were 235,600 passenger cars
- 36,700 kilometers of roads, 2,125 kilometers of railroads and 9 major airports
- There were 710 hospitals and 4,528 schools (76% rural)
- The most important economic activities in Azerbaijan are the oil and natural gas industries in the Baku area, parts of the interior and the Caspian Sea offshore
- Other industries include steel products, chemicals, cement, timber, salt, textiles, carpets, oil drilling equipment, engineering, light industry and food processing
- Gross Domestic Production (GDP) of $5.43 billion in 2002 with growth at 6.1%
- GDP per capita of $680
- 30% of the population is engaged in food production, which represents 27% of the GDP
- Inflation rate in 2002 was 2.6%

While agriculture is a vital component of the economy, Azerbaijan still imports 70% of its food requirements. Privatization has made greater progress in agriculture than in any other economic sector. More than 50.0 thousand farms have been restructured and placed in the hands of independent owner/operators along with hundreds of small to medium-sized agribusinesses, food production/processing facilities and other types of rural enterprises.

[1] 2002 Statistical Yearbook of Azerbaijan and 2002 CIA Fact Book.

Although the Caspian fishery is a major contributor to the nation's food needs, it remains still largely under state control but important nevertheless towards food production, income generation, exports and the creation of jobs.

Along with a normal variety of livestock (predominantly sheep and cattle), poultry, dairy, horticulture, aquaculture and basic grain (including rice) farming systems, Azerbaijan because of its several microclimates, cultivates a number of high-value and niche cash crops that represent good export potential such as exotic fruit orchards, a variety of confectionery-nut groves and vineyards.

2. Background of the Institution CredAgro – The Azerbaijan Rural Credit Project (ARC) began implementation during the second half of Y2000 and **CredAgro, a Non-Bank Financial Institution**, was chartered towards the end of the same year. During its early months of existence, CredAgro made no loans but in the latter part of the same year and during the beginning months of Y2001, it became operational in terms of the recruitment of start-up professional and support personnel; the establishment of its headquarters in Baku; and the development of rudimentary but adequately rigorous policy, procedure and operating guidelines. Next came the research and marketing survey process leading to the establishment of four regions representing the agricultural heartlands of Azerbaijan in the northeast, the northwest, the south and the single Rayon encircling the capital. Utilizing its agricultural experience gained under the USAID Farmer-to-Farmer (FtF) Project, ACDI/VOCA was in an excellent position to identify the Rayons (districts) with the best potential and the highest density of private farmers, agribusiness and rural entrepreneurs. Over the course of the following eighteen months, local staff was recruited and nine CredAgro Branch offices were established and located as follows:

- Absheron Peninsula (Baku)
- Gelilabad (South)
- Quba (Northeast)
- Ismailli (Northwest)
- Khacmaz (Northeast)
- Lenkoran (South)
- Masalli (South)
- Tobuz (Northwest)
- Zagatala (Northwest)

Lending began at about the Y2001 mid-point and at the onset, very slowly and painstakingly due mainly to a lack of understanding by the small to medium-scale farmers of credit generally; a limited and cautious promotional thrust on the part of CredAgro so as to avoid an anticipated (wrongly) deluge of applicants; a lack of experience and lending know-how on the part of the newly hired CredAgro personnel; and a high-level of difficulty in the ability of CredAgro to initially identify appropriate assets and the applicants inability to pledge suitable collateral for the securing of loans. By March 2002, however, with all of the Branches now operative and most of the original staff (at both CredAgro headquarters in Baku and all nine Branches) in place and oriented to their jobs, lending soared.

4. The CredAgro Mission Statement – CredAgro is a non-profit, non-governmental lending institution, which provides access to working capital and investment loans for Azeri farmers and agriculturally related rural enterprises that have difficulty obtaining credit from other sources. Lending decisions are predicated by the understanding that 100% repayment is expected on all loans approved and that repayment will be generated from the borrower's overall cash flow and incremental income earned from the project being financed. By doing so, CredAgro seeks to improve the financial well-being and standard of living of borrowers and to enhance the economic development of Azerbaijan.

5. The CredAgro Founding Strategy –

- Maintain direct control over the loan capital fund and rural credit system at the onset and create an enabling environment for on-the-job training, human resource development and beneficiary confidence and loyalty build-up

- Grow the rural credit system from a centrally managed loan capital fund to a network of Branches with local representation, democratic control, owner/user investment and regional policy determination and management decision-making influence

- Build the rural credit system on existing trust and credibility within the communities and in the existing legal and business environment using local experts for business development and technical support

- Engage beneficiaries in the future capitalization of the rural credit system early so that in time, they will become the ultimate owners and leaders of the institution and eventually, the decisive factor in the determination of its destiny

- Seek supplemental sources of loan capital near the beginning of the above process

6. CredAgro Credit Policy and Procedures Abstract –

- CredAgro will not process applications from peer or solidarity types of group borrowers such as the type of lending conducted by the traditional Microfinance projects being implemented by the Azeri and International NGO community

- The minimum size of loans is $500 and the maximum $30,000

- Loan pricing will range between 18% and 25% and will be determined by the credit risk of each borrower (the expense of providing for loan losses); an imputed cost-of-funds factor; operating costs; foreign exchange risk[2]; and of course, inflation

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[2] At present, all CredAgro loan agreements are denominated in US Dollars and repaid at the Azerbaijan Manat equivalent-of-the-day foreign exchange rate. This foreign exchange risk policy "buffer" will be reconsidered once the entire US Dollar capital portion of the ARC Project has been fully re-cycled (about the Y2004 mid-point) and changed then probably, to reflect more appropriately in the loan "interest rate pricing" strategy thus **re-distributing the foreign exchange risk** in its entirety from the "shoulders-of-the-borrower" to an equitable **split between the lender and the borrower**

- All credit approvals, depending on the level of authorization, will be carried out by either the CredAgro Supervisory Council (see below), the CredAgro Credit Committee or as delegated to the CredAgro Branch Credit Committees as established

- The Supervisory Council will appoint the CredAgro Director

- All CredAgro loans must be fully secured at a coverage ratio for first time borrowers of 200% and for repeat borrowers once repayment track records have been established, at a coverage ratio of 150%

- Repayment terms will not exceed 18[3] months

- Loan monitoring and credit auditing procedures will be in place and the function established (Y2002 Business Plan)

- The CredAgro Director will have direct responsibility for the day-to-day supervision and oversight of all delinquency and monitor closely, the follow-up as it is carried out at the Branch level

- CredAgro will monthly, expense and allocate to a reserve for loan losses, **the greater of**: (i) - the standard CGAP formulae; (ii) – 3% annually or on a monthly accrual basis, 0.25% of the 12 month moving average value of the portfolio, or; (iii) – the formulae as prescribed by the National (Central) Bank of Azerbaijan

7. Operational and Financial Highlights as of December 31, 2002 and Comments – Although the financial statements at the time of the preparation of this paper had still not been audited, the writer believes that all of the data contained below, represents fairly and accurately but still approximately, the operational and financial highlights:

- <u>The Balance Sheet</u>:

Cash, etc. -	$[4]400.0	thousand
Loan Assets -	2.1	million
Fixed Assets, etc. -	100.0	thousand
Total Assets -	**<u>$2.6</u>**	**<u>million</u>**
Total Liabilities -	Nil	
Paid-in-Capital[5] -	5.0	thousand
Donated Capital[6] -	2.2	million
Retained Earnings[7]	385.0	thousand
Capital Reserve	10.0	thousand
Total Liabilities/Equity	**<u>$2.6</u>**	**<u>million</u>**

[3] Depending on the Y2003 demand for the existing short-term/working capital form of loan and the liquidity supply situation – an asset financing type of term-loan or financial lease product may or may not be introduced (or "piloted", at least) – extending repayment terms to perhaps two, three or even four or five years
[4] USA Dollars
[5] ACDI/VOCA founding capital investment
[6] ARC Project (USAID) Capital Contribution to date – plus/minus $1.0 million remaining
[7] ARC Project 100% Operating Expense Subsidy (100% to June 30, 2003; 75% to June 30, 2004; and 50% to June 30, 2005/end-of-ARC Project)

- The Income Statement:

Financial Income[8] -	$241.4	thousand
Operating Expenses -	380.1	thousand
Financial Expenses[9] -	10.0	thousand
ARC Project Subsidy -	380.1	thousand
Net Income -	**$231.4**	**thousand**

- Number of Active Clients plus/minus 600 ($3500 average size loan) of which – approximately 2% are women[10] (Y2002 Business Plan target is to increase to 20% by end-of-project and gender-based training activity planned for this year). The agricultural sub-sector percentage breakdown of borrowers is as follows:

  - Livestock and Poultry – 50%
  - Field Crops, Horticulture, Orchards, etc. – 22%
  - Agricultural/Food Processing – 3%
  - Off-farm Agribusiness – 19%
  - Rural Infrastructure – 6%

- Delinquency is currently (December 31, 2002) running at 1.7% and penalty fees are charged for late or overdue payments

- CredAgro, given the fact that it operates almost exclusively within the rural areas of Azerbaijan that are generally perceived as liquidity deficient or a savings "lean" environment, **does not engage itself (nor will its charter allow) in the mobilization of public savings deposits**. However and as expanded upon within the issues to be faced and the problems to be solved below, it anticipates a need for additional lending capital either towards the end of the current year or no later than early Y2004 if the seasonal lending demand peak anticipated at that time is to be satisfied and overall growth and profitability maintained. The need for growth (and therefore earnings) is intensified by the diminishing ARC Project subsidization

- CredAgro currently, has a total staff complement of thirty-eight operational personnel consisting of senior, regional and branch management; headquarter support staff; and branch loan officers and bookkeepers. Several drivers and branch custodians round out the human resource complement. No further branches are expected to be opened in the foreseeable future although further outreach to additional Rayons from existing branches and with existing loan officers is part of the Y2002 growth strategy.

- The break-even case load for CredAgro Branch Loan Officers is approximately 15 borrowers but with added vehicles (to be purchased); the increasing number of 2nd time and repeat borrowers taking larger loans; planned MIS and accounting system enhancement at the branch (and headquarters) distribution points; and as overall experience and operating performance efficiency increases – the loan officer case load capacity is much greater and will continue to improve

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8 Portfolio yield at December 31, 2002 at plus/minus 16% and not the 20 to 22% one would expect due to the exponential build-up of loan assets during the 3rd and 4th quarters of Y2002 creating a distortion to the average portfolio yield for the year

9 Allowance for Loan Losses (a non-cash expense and not covered under the ARC Project subsidy). No real cost-of-funds or imputed cost-of-funds

10 The ARC Project contains no specific women borrower targets

- Under the ARC Project, technical assistance is provided by two ACDI/VOCA medium-term advisors – one an agricultural credit, microfinance and rural banking specialist (yours truly) and the other - a specialist in institutional strengthening and training. As mentioned at the beginning of this report, ACDI/VOCA is also implementing on behalf of USAID, a comprehensive Farmer-to-Farmer (FtF) Project which, after the visit of a number of Volunteers, has added an important (and very cost effective synergy) technical assistance input to CredAgro in a variety of specialized areas.

8. The Lessons that have been Learned –

- Through both mistakes and successes – CredAgro has learned quickly that good people and the identification, recruitment, development and retention of good people is the key factor in the determination of any kind of organizational achievement – but particularly – a financial institution dealing primarily in agriculture (a high-risk sector under any conditions) and in the rural areas of a young nation caught-up in the rapid transition and reform of its economy. New ideas and new ways of doing things require ***personnel who can adjust to change*** foremost and also adapt to local conditions and the local business-culture. Technical expertise, albeit as important as it would normally be, is difficult to find in an emerging economy and therefore, must be compensated for with other but still practical experience credentials

- Many of CredAgro's initial clients are also farmers and rural entrepreneurs who may have never borrowed before – anywhere or at any time. With non-existent borrowing track records, therefore, special criteria must be developed and have been developed to first of all identify the type of would-be borrower that will be also become a successful borrower. Although the **"Five C's of Credit"** are enveloped within the CredAgro formal loan appraisal process – for the purpose of potential borrower identification – CredAgro has incorporated a Pre-Qualification process incorporating an additional ***"Three C's of Credit Pre-Qualification":***

    - ***Credibility in the community***

    - ***Confidence in the project to be financed***

    - ***Competence in implementing the project to be financed***

- A third lesson learned has been in understanding that ***borrowers require to be served*** efficiently, particularly new borrowers and that where good service is being provided, problems are discovered sooner; confidence in CredAgro is established earlier; and client loyalty in CredAgro becomes unshakable vis-à-vis the competition

- ***Tricks-of-the-trade*** are being adapted as experience build-up occurs particularly in the complicated, time consuming and oftentimes expensive legal requirements involved in the notarization and registration of loan agreements; the appraisal of collateral and the filing of collateral documentation; the disbursement and transfer of funds back-and-forth through banks; and in the areas of time and cost efficiencies gained when ***work is well planned, organized and prioritized*** and long-distance travel economized by making one trip serve a number of different purposes

- The economic and agriculture diversity in the several regions of Azerbaijan require local and specialized insight into the unique problems attached to the different farming systems; livestock/poultry weight gain and cost-of-production standards; horticulture and field crop yield requirements; and above all, marketing and farm prices intelligence. Many of the ***CredAgro credit staff are not agronomists*** by profession but through discovery, observation and attention to reliable sources of data – they have ***learned the more technical side of agricultural lending***, at least to the extent necessary to make better loans

9. The Current Issues to be Faced and the Problems to be Solved –

- **Governance, Ownership and Control** – As the founder of CredAgro, ACDI/VOCA under the ARC Project, is charged with the responsibility to build an institution that will engage the beneficiaries being served, who will ultimately become the owners and policy-makers of the institution and thereby, controllers of the credit system and its longer-term destiny. During the upcoming business year, a Supervisory Council (in lieu of a Board of Directors) will be established, which will be the first step towards beneficiary representation and provide the gateway and hopefully the leadership, to their (the beneficiaries) eventual investment, ownership and control. While ACDI/VOCA (The Country Representative) shall participate in and ratify all of the appointments to the Council and serve as its Chairperson, efforts will be made to democratize the process and bring at least in part, branch system representation to it. A council of seven members (including the Chairperson) will be nominated - two to be selected by the Chairperson and representing outstanding Baku community leaders and executives from the business, legal, banking or agricultural/food production sectors. One such individual has potentially been identified and displayed his early interest in serving. Additionally, Regional Advisory Councils shall be established at each of the four regions and will consist of beneficiary/client representation from the existing nine CredAgro Branches and whom the borrowers at each location might possibly elect. The duties and responsibilities of the CredAgro Supervisory Council shall include: (i) - the review and approval of all policy and procedures; (ii) - the approval of all applications for credit exceeding $30,000.00; (iii) - the appointment and performance review of the CredAgro General Director; (iv) - the confirmation of all personnel appointments that report directly to the CredAgro General Director; (v) the write-off of all CredAgro loans to bad debt and the determination of the adequacy of the reserve for loan losses; (vi) - the approval of all CredAgro annual business plans and operating budgets; (vii) - the appointment of CredAgro external auditors; (viii) - the review at least quarterly of all CredAgro financial statements and operating results; (ix) - the approval of all new credit products, capital expenditures and branch expansion and; (x) - the approval of the source, the cost and the conditions attached of all CredAgro external debt and/or all additional capital investment.

- **Debt and Equity Capital** – Although relatively certain of an adequate supply of liquidity (ARC Project capital budget plus retained earnings) for the duration of the Y2003 business year, CredAgro will almost certainly not be able to sustain its growth projection without the procurement of additional capital for lending beyond Y2003 year-end. Some initial interest has been displayed and some preliminary discussion has already occurred between ACDI/VOCA on behalf of CredAgro, and the international donor/financial community (e.g. Asian Development Bank, IFC/World Bank, the international petroleum sector located and operating in Azerbaijan, etc.) in terms of capital investment.

Additionally, commercial debt possibilities if available at a realistic cost and under reasonable conditions and terms represent other funding options that CredAgro will be pursuing beginning early in Y2003. With a near "gilt-edged" loan asset portfolio available for hypothecation and an earning track record in the process of being established coupled with the core capital USAID granted under the ARC Project, CredAgro should be in a position to leverage its balance sheet, conservatively of course, in terms of increasing its liquidity supply from commercial debt sources as well as attracting capital investment on the part of the donor community. Beyond this, however and during Y2003, CredAgro must entertain appropriate and ways and means of attracting suitable investment capital (and possibly public savings and/or commercial/institutional deposits) from beneficiaries within the communities it serves both now and in the future. Although not a credit or financial cooperative per se but still under its existing quasi-NGO form of charter, there are a number of innovative approaches that CredAgro might explore in terms of generating beneficiary interest to invest and creative methodologies that would actually facilitate and make investment easier thus gradually, converting the "beneficiaries" to legitimate "stakeholders" with the possibility of becoming over time, the majority owners and the eventual controllers. This shall be a particularly important area of focus during the upcoming business year.